STATEMENT BEFORE THE HOUSE
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

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I am honored to be here today, on behalf of HUD Secretary Mel Martinez, to describe the efforts by the Secretary and HUD's Office of Housing to address the problems caused by fraud and abuse in FHA's Section 203(k) property rehabilitation program during 1998 and 1999, here in New York City. This is an important hearing to address a major abuse of HUD programs, and we believe that Chairwoman Kelly and Congressman Rangel deserve thanks for conducting this hearing. I also want to thank Commissioner Jerilyn Perine of the New York City Department of Housing Preservation and Development (HPD) for her strong commitment to solving the problems that now confront us all in these properties.

The Department has engaged in an intense effort to understand how the program abuse occurred, how it can best be addressed, and how it can be prevented in the future, here and elsewhere. I will first summarize our current findings and the actions we have taken, and then identify future steps.

With me is Sean Cassidy, General Deputy Assistant Secretary for Housing, who has had direct responsibility for working with our New York office on this problem, on a day-to-day basis. I am also accompanied by the Secretary's Representative in our New York Office, Mary Ann Wilson; by Frederick Douglas, Deputy Assistant Secretary for Single-Family Housing; Joseph McCloskey, Director of the Office of Single Family Asset Management, and Engram Lloyd, Director of the Philadelphia Home Ownership Center. All of these HUD staff members have worked long and hard on this problem.

The 203(k) Program

The Section 203(k) program is the Department's primary program for the rehabilitation of single-family properties. As such, it is an important tool for community and neighborhood rehabilitation and for expanding homeownership opportunities. Under Section 203(k) of the National Housing Act, the FHA is authorized to insure mortgages that finance both the purchase of the home and the repair of the property after purchase. Participating lenders are required to approve "draw-downs" from a repair escrow, and to ensure the adequacy of the repairs themselves. The 203(k) program, as it exists today, was created in 1978. From Fiscal Year 1995 through the end of Fiscal Year 2000, FHA insured over 82,000 mortgages under the provisions of Section 203(k). During the first ten months of Fiscal Year 2001, we have insured another 7,000. It should be noted that, while 203(k) is a single-family home mortgage program, it is possible to obtain FHA insurance for properties with up to four units and larger properties being converted to no more than four units. Properties with one to four family units are defined by statute as "single-family" for the purposes of FHA mortgage insurance. Of the 203(k) mortgages insured from Fiscal Year 1995 through July, 2001, 80% have been on one-family properties, 11% have been on two-family properties, and 9% have been on three- or four-family properties.

The 203(k) program is inherently more risky than FHA's standard home mortgage insurance, because of the repair component. The actual cost of repairs may vary from the original estimate; the repairs may take longer than anticipated; the value of the repaired property may turn out to be less than expected when the loan was underwritten and the mortgage amount insured by FHA is based on the "as-is" value of the property *plus* the estimated costs of allowable repairs (within the overall FHA loan limit cap). FHA has a 14 percent serious default rate on 203(k) loans, compared to 2 percent on the basic 203(b) home mortgage insurance. (Serious defaults are defined as 90-day delinquencies.) The insurance claim rate is about 4.2 percent on 203(k), compared to 0.6 percent on 203(b). The claim rate on 203(k) loans held by non-profits is significantly higher – 10.2 percent.

Program Abuse in New York City

To understand the fraud that occurred in New York, some history is useful. In February 1997 HUD's Office of the Inspector General issued an audit report on the 203(k) program, which was highly critical of the existing management controls. In response to an interim report on this audit, on October 29, 1996 FHA suspended participation by investors in this program. A number of investors circumvented this prohibition, in order to commit fraud, by persuading various nonprofit groups to front for them on the purchase of homes using the 203(k) insured financing. During 1998 and 1999, FHA insured mortgages on 720 properties in and around New York City that were sold to non-profit organizations under HUD's 203(k) insurance program. Most of these properties were located in Brooklyn, Harlem, or the Bronx. The properties were sold to 54 non-profit organizations, which had previously committed to rehabilitate them and resell them in support of community enhancement and affordable housing objectives.

In fact, the actual purchase, renovation, rental and/or resale was conducted by companies with ties to loan officers. Escrowed monies to be used for property rehabilitation were then funneled to so-called developers, who actually did little or no rehabilitation. Kickbacks were paid to the various parties involved in the fraud. Lenders failed to perform their legal duties to ensure that repairs were completed, and that escrow funds were handled in a responsible manner; some were in collusion with the investors.

Within a year, reports from local community groups, HUD "quality assurance reviews" of lenders' operations, and assessments by HUD staff of non-profit participants, revealed a pattern of program abuse that included collusion among non-profits, investors, appraisers, property owners, real estate agents, rehabilitation firms, originating lenders and mortgage servicing companies. An overwhelming number of these loans were apparently originated under false pretenses and are the subject of on-going investigation by the Department of Justice, local authorities, and HUD's own Office of the Inspector General. FHA has been advised that 33 individuals have been indicted to date.

Most importantly, several hundred households are living in appalling conditions. Last week, Mr. Cassidy, Ms. Wilson, Mr. Lloyd, and I looked at 42 of these properties, here in Harlem and also in Brooklyn. We saw vacant lots, burned-out buildings, buildings with missing steps on the front staircase, buildings with broken windows.

Many were boarded up; about half were occupied or partially occupied. Nearly all need significant rehabilitation before they can provide decent housing.

Addressing the Problem

On January 17, 2001, then Secretary Andrew Cuomo signed a Memorandum of Understanding (MOU) between the Department and four nonprofit organizations located in New York City, to address disposition of these properties. Upon his appointment, Secretary Martinez reviewed the MOU; he was concerned that the cost, effectiveness and legality of the MOU had not been determined before it was signed. In reviewing the MOU, HUD legal counsel and program staff identified several concerns. The MOU did not entail a comprehensive commitment to address the problems in all of the properties; it gave the nonprofit signatories the right to refuse transfer of any of these properties, which could result in HUD retaining title to those properties in the worst physical condition. That would certainly complicate neighborhood preservation efforts. The MOU would have violated federal contracting requirements for employing property management firms. In addition, there was no financial analysis of projected repair costs; instead, there was an open-ended commitment of federal resources for rehabilitation. HUD would have abdicated its responsibility to determine the level of rehabilitation that should be undertaken and the cost to the federal government.

Secretary Martinez' foremost concern was for the welfare of the tenants. He directed a HUD team be formed immediately, located in New York City and dedicated to ensuring the appropriate management and disposition of these properties. On May 11, 2001, Secretary Martinez announced the Department's commitment to address the problem. HUD's policy would be:

- To protect all current legal residents and offer them affordable leases;
- To bear the costs of any temporary relocation made necessary by rehabilitation of the property;
- To allow for the disposition of the properties to both for-profit and nonprofit purchasers;
- To bring the property up to minimum property standards (i.e. free of health and safety problems, and supplied with adequate heating, plumbing, electricity, and other basic utilities); and
- To pay the cost of rehabilitating the properties.

To further his commitment to addressing the problem, Secretary Martinez met personally with representatives of the four original signatories to discuss their concerns; from HUD's standpoint, our issues involve the MOU itself, not the signatories. In addition, the Secretary invited HPD to assist in developing a solution that would result in the successful rehabilitation of the properties and their sale to responsible owners.

Insurance claims on these properties are expected to exceed $130 million, which is not inclusive of the costs for property rehabilitation. HUD's initial cost estimate for the rehabilitation was $80 million. In addition, the Department committed to an investment of $25 million for affordable homeownership through purchase money mortgages and affordability discounts.

It is important to note that HUD currently owns only 156 of the properties in question. Another 460 properties are in default, but the sponsors remain the legal owners of record, even though they are now excluded from doing new business with HUD. The Department is urging these owners to manage and maintain the properties, and provide basic utilities to the tenants, but our efforts have been met with considerable resistance. Nevertheless, the HUD project team, led by Secretary's Representative Mary Ann Wilson, is working closely with city officials, mortgage servicers, and community groups, to ensure that basic services such as heating and electricity are available to tenants in all of these properties. When problems are detected, the Department has instructed the mortgage companies currently servicing these loans to directly intervene to re-establish these services, an expense for which they are reimbursed by HUD.

In response to the Secretary's proposal, HPD has recently offered to assume a primary role in overseeing the rehabilitation and disposition of the properties. HPD would draw on its extensive experience in rehabilitating similar properties in New York – in many case properties on the same blocks. HPD's programs have involved some of the signatories to the MOU and other nonprofit and for-profit entities. The Department welcomes this proposal. It is now under active consideration by program staff and the Office of General Counsel. In the interim, the Department is utilizing two property management firms to maintain these properties, establish leases consistent with applicable New York City laws, pay taxes, and ensure that basic utilities remain operational for the properties that are now being conveyed to the Department following foreclosure.

Prosecuting Fraud

As I mentioned earlier, the Department of Justice has active investigations now underway, and HUD staff are supporting both Federal and state investigations. Wherever possible, the Department has proceeded with administrative actions as well. Between October 1, 1999 and August 24, 2001, the Department initiated a wide range of actions against 113 organizations and individuals involved in FHA-insured loans in New York City.

- 83 on-site reviews of lenders have been initiated or completed.

- During this period, HUD's Mortgagee Review Board has taken or is in the process of taking administrative sanctions against 23 lenders within the area. FHA approval has been withdrawn from 5 lenders, and HUD has imposed $1.04

million in civil money penalties. Seven lenders have executed settlement agreements, indemnifying HUD/FHA on losses on 90 loans.

- 3 lender branch offices have been proposed for termination or terminated under the Credit Watch Termination initiative, and another 11 have been placed on warning status as a result of high default and claim rates.

- 8 lenders are under investigation by the Office of the Inspector General.

- 9 lenders were placed in 100% post-endorsement technical review status; HUD staff will review a sample of loans that have been closed and evaluate the lenders' underwriting after the fact.

- 8 lenders were placed in pre-closing review status; the staff in HUD's Home Ownership Center must re-underwrite the loan before it can be closed.
- 7 appraisers have been removed from the FHA Roster; they are no longer permitted to appraise loans for FHA insurance.

- 16 individuals have been referred to the Departmental Enforcement Center for debarment.

- All 54 of the non-profit groups involved are no longer eligible for participation in Single Family programs.

Program Changes to Prevent Future Problems

In addition, the Department is carefully analyzing 203(k) program activity to determine if the situation in New York is indicative of similar problems elsewhere in the country. While problems have been detected with the program, at this time there is no indication that there are other instances or problems that match the scope and depth of impact we have experienced in New York City.

For 203(k) mortgages insured in or after Fiscal Year 1995 to non-profit mortgagors, the cumulative claim rate is 14 percent for loans in New York City, compared to 5 percent for the rest of the country

Since my appointment as FHA Commissioner on June 1, 2001, I have analyzed the programmatic factors that have contributed to this truly tragic situation. There seem to be two primary factors: (1) the involvement of non-profit groups in a volume of work which in many cases exceeded these groups' capacity to perform; (2) the fact that many of the properties were multi-unit buildings and could not be converted to single family residences due to city code restrictions. This combination of factors, combined with the use of the high-risk 203(k) program, created an environment in which fraud could at least temporarily flourish.

The non-profit program has now been changed in several important ways, with the intent to forestall a recurrence of this type of fraud elsewhere. The Department established uniform approval, re-certification, and reporting procedures for non-profit groups. These procedures dramatically reduced the number of nonprofits that are eligible to participate in FHA single-family programs, removing those who did not have the qualifications to do the work. We have also developed and implemented clear guidelines for removal of non-profits participating in FHA activities. In addition, we have limited the number of active 203(k) developments per non-profit to a total of 10. These changes were incorporated in HUD Mortgagee Letter 00-08, issued March 3, 2000. The Department is now contemplating more rigorous controls. I hope to present a series of proposed regulations for public comment and Congressional review within the next few months.

In conclusion, I want to emphasize that Secretary Martinez and the Department, and most particularly FHA, will continue to rigorously review program operations and the program control structure. We are prepared to develop new regulations to modify the specific features of the program that have facilitated these abuses. We will also work with the City of New York, with community groups, with nonprofit and for-profit entities, and with the unfortunate residents of these properties, to make sure that the residents are able to live in decent housing and the buildings do not weaken the neighborhoods in which they are located. The Secretary’s first concern is that the families who are living in these properties are decently housed and do not suffer from the fraud that occurred around them. Finally, we will continue to hold lenders, servicers, and other participants accountable for fraudulent activities and for failure to comply with the requirements of our programs.